APPENDIX D
INSIDER TRANSACTIONS OF PUBLIC CHARITIES

The Discussion Draft proposes to apply the private foundation self-dealing rules to public charities – essentially to replace Section 4958 with Section 4941, with the exception of compensation paid to insiders, which would be addressed through revisions to the Treasury Regulations under Section 4958.

We believe that this proposal was prompted by legitimate concerns regarding a narrow set of potentially abusive transactions by a relatively limited number of public charities. We share the concern that abusive transactions be identified and curtailed, and that the legal regime for public charities be designed both to discourage and to disclose such transactions. We also believe that the distinction that Congress drew between public charities and private foundations in 1969 remains valid, however, and that there are sound justifications for applying different regulatory regimes to these two categories of charitable organizations. Public charities achieve that classification by demonstrating that they have characteristics – either by the nature of the services they provide, the public sources of their support and governance or their relationship to another public charity – indicative of a measure of public oversight.[1] A public charity may not be fully funded by and controlled by one or handful of private entities or individuals. There is less potential for abuse by public charities than in the private foundation context. Indeed, it is common practice for public charities to recruit board members in part because of the benefits that the board member may be able to offer the charity – such as the provision of below-market goods or services to the charity. It would be unfortunate to foreclose this important source of support for many charities in the name of curbing abuse.

Congress enacted Section 4958 to impose excise tax penalties on disqualified persons who received excess benefits in transactions with public charities, and on any organization managers who knowingly approved such transactions. At that time, Congress considered and rejected the idea of extending the self-dealing rules to public charities, concluding that the self-dealing rules would be not only overbroad and burdensome but also unnecessary. We believe that it is premature to conclude that Section 4958 has not provided sufficient safeguards and deterrence against abuse in public charity transactions with insiders. The statute was enacted in 1996, and final Treasury Regulations were released only in early 2002.[2] As practitioners, we have already seen positive changes, particularly as a result of provisions in the Treasury Regulations that allow EOs to establish a rebuttable presumption that a transaction is reasonable when it is approved by the disinterested members of a board or board committee, based on appropriate comparability data and documented in writing.[3] These provisions encourage EOs to obtain information regarding comparable compensation packages

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[1] *See* IRC Section 509.

[2] We note that the enactment of IRC Section 4958 roughly coincided with the IRS reorganization, during which resources that might otherwise have been allocated to enforcement were directed to other needs. This suggests to us that the years since the enactment of IRC Section 4958 may not have been a fair test period for the new rules.

[3] Treas. Reg. § 53.4958-6.

and to have full disclosure and review of compensation matters, in advance, by the independent members of the organization's board.

As existing compensation arrangements are audited and enforcement actions are brought – and won – by the IRS, there will be additional changes in behavior. The IRS has achieved initial positive results in litigation.[4] As the IRS issues additional guidance and the courts continue to interpret Section 4958, we anticipate that EOs and their disqualified persons will develop a better understanding of the boundaries and the potential for penalty excise taxes, and will modify their behavior accordingly. We also note that some multi-year contracts that were in place in 1995, before the effective date of the intermediate sanctions provisions, may only now be coming up for renewal – in effect, they are being subject to intermediate sanction review for the first time.

Turning to the Discussion Draft proposal, we offer the following examples of common types of transactions with public charities, all of which would be prohibited under the Discussion Draft's proposal, even where they would clearly benefit the public charity and even where any benefit to the disqualified person is objectively not excessive:

- A board member leases office space to a public charity at below-market rent sufficient to cover only out-of-pocket operating costs of the lessor;

- A company owned 50% by the spouse of an officer at a private school sells curriculum materials to the school at a price that is the best the charity could obtain with reasonable effort;

- A board member loans funds to a public charity museum at below-market rates to allow it to acquire a painting that has unexpectedly come on the market;

- A scientist, serving on the board of a public charity research institute because of her deep background in the institute's research discipline, licenses intellectual property to the institute for use in its research at a price below fair market value, as established by comparable licenses of the same intellectual property to unrelated parties;

- A University, in order to secure the services of a new department chair or key administrator moving from a lower-cost housing area, provides a below-market mortgage loan secured by the property being financed;

- A job training organization leases equipment for student use from a substantial contributor at significantly below-market rates.

To prevent or eliminate the abuses that have been identified in the public charity arena without prohibiting transactions that are beneficial to public charities, we suggest the

[4] *See Caracci v. Commissioner*, 118 T.C. 379 (2002).

adoption of more narrowly focused reforms. For example, with regard to loans involving disqualified persons, public charity loans might be restricted to employee or staff relocation loans that are permitted under state law. Public charities could be required to attach a schedule to Form 990 of all loans to disqualified persons, with disclosure including the date of loan, face amount, outstanding balance, interest rate and term.

While Form 990 currently requires disclosure of transactions with officers or directors, we suggest that requiring responses to specific questions would provide more transparency and also provide the IRS with a method of identifying electronically those returns where loans are reported. Perhaps a series of questions similar to those on the Form 990PF would be appropriate. Similarly, the IRS might require more detailed Form 990 disclosure of all sales of assets between disqualified persons and public charities with a purchase price in excess of a threshold amount. We are prepared to provide additional examples of targeted provisions upon request.